APPENDIX A

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

Civil Action No. 16382

MOHAWK LIQUEUR CORPORATION, *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*.

Opinion

Mohawk Liqueur Corporation, herein referred to as taxpayer, paid certain assessed income and excess profits tax deficiencies and now sues for a refund. The facts have been stipulated. Taxpayer manufactures and sells various liqueurs, wines, and distilled liquors and thus was liable for, and paid, certain federal taxes (floor stocks taxes) on its stocks of distilled spirits. The issue which is now before the court is whether the cost originally assigned to the basic "last-in, first-out" (LIFO) inventory should be adjusted for the floor stocks taxes subsequently levied, as the Government contends, or whether the taxes should be considered current expenses of the years in which they were assessed and paid, the view contended for by the taxpayer.

A necessary step in the calculation of taxable income for any period is the determination of the "cost" of the closing inventory. LIFO assumes that the articles sold during the taxable year were those most recently purchased so that those remaining in inventory are assumed to be the first items purchased. Thus, the "cost" of the closing inventory is ordinarily determined by the cost of acquisition of the first items purchased. The object of the LIFO fiction is to match current expenses more closely to current income, since the cost of the last item of inventory is

usually closer to the replacement cost of the item than is the price of the first bought. In theory, this method makes the income statement of a going concern more accurate although it results, in time of rising prices, in an increasingly undervalued inventory.

Taxpayer elected the LIFO method of inventorying its distilled spirits and finished products on October 1, 1942, as allowed by Section 22(d) of the Internal Revenue Code of 1939,[1] (re-enacted without important changes as Section 672 [sic], Internal Revenue Code of 1954, 26 U.S.C. 472). Taxpayer subsequently filed its returns on that basis. The validity of its election is not disputed.

In its first LIFO opening inventory, taken as of October 1, 1942, taxpayer included the $4 per gallon excise tax[2]

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[1] Section 22(d)(1). A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

* * * * * *

(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

[2] Revenue Act of 1941, Sec. 533, 55 Stat. 487 (1941), amending Internal Revenue Code of 1939, Sec. 2800(a) (now 26 U.S.C. § 5061(a)).

which it had previously paid as part of the cost of the spirits in its inventory. Effective November 1, 1942, Congress increased this tax to $6 per gallon.[3] As the excise tax attached to the spirits only on distillation or removal from bond; this change did not affect taxpayer's basic LIFO inventory, which consisted only of spirits already distilled or removed from bond, and hence, is not in issue. However, Congress, in the same act, effective November 1, 1942, enacted a floor stocks tax of $2 per gallon payable on all distilled spirits held for use in manufacturing or for sale on which the previous $4 per gallon excise tax had been paid.[4] In 1944, the excise tax was raised to $9 per gallon,[5] and a $3 per gallon floor stocks tax was enacted.[6] In 1951, the excise tax was raised to $10.50 per gallon,[7] and a $1.50 per gallon floor stocks tax was enacted.[8]

Thus, the spirits, which, under LIFO theory were assumed to have been continuously in the taxpayer's inventory, were subject to four separate excise taxes. The first was the $4 per gallon excise tax which had attached before taxpayer changed to LIFO. The second tax was the $2 per gallon floor stocks tax which attached to them on November 1, 1942. The third was the $3 per gallon floor stocks tax which attached on March 1, 1944. The fourth was the $1.50 per gallon floor stocks tax which attached November 1, 1951. Each of those four taxes was paid by the taxpayer. The Government does not dispute the correctness of taxpayer's treatment of the original $4 per gallon tax as part of the cost of the LIFO opening inventory. The

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[3] Revenue Act of 1942, Sec. 602(a), 56 Stat. 798 (1942).

[4] Internal Revenue Code of 1939, Sec. 2800(j).

[5] Revenue Act of 1943, Sec. 302(a), 58 Stat. 21 (1944).

[6] Internal Revenue Code of 1939, Sec. 2880(k) [sic].

[7] Revenue Act of 1951, Sec. 451(a), 65 Stat. 452 (1951).

[8] Internal Revenue Code of 1939, Sec. 2800(l).

issue thus narrows to the question of the proper treatment of the three floor stocks taxes.

While Section 22(d) is by no means crystal clear, a careful reading of its language and of the pertinent treasury regulations supports the taxpayer's position. Section 22(d) requires the goods to be inventoried at "cost" and requires that the taxpayer "treat those remaining on hand at the close of the taxable year as being: first, those included in the opening inventory of the taxable year . . ." "Cost" is defined in Treasury Regulations 111 Par. 29.22 (c)-3 as follows: "Cost means: (1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods." Hence, the "cost" of "those included in the opening inventory" is taken as the "inventory price." This, in turn, could only be the "price" assigned to the goods for the preceding closing inventory, which was, in turn, calculated in the same way. This successive reference back is the heart of the LIFO method. Since "cost" for each year is the same as "inventory price", which, in turn, is merely "cost" from the preceding year, it necessarily implies that "cost" (for goods considered as continuously in inventory) is constant once the goods have entered the inventory. We thus find the price of the goods to be the price assigned to them as cost of acquisition at the time acquired, or the time when LIFO was first instituted. Rebate [sic, probably should be "Hence,"] "cost" could not include the subsequently enacted floor stocks taxes.

The legislative history of Section 22(d), although meager, supports this interpretation. The first version of this section, which appeared as a Senate floor amendment to the Revenue Act of 1938, used the words "last-in, first-out." It applied to most taxpayers with fungible inventories and read as follows:

> "The cost of goods sold during any taxable year beginning after December 31, 1938, may be computed on the last-in, first-out basis if such basis conforms

as nearly as may be to the best accounting practice in the trade or business, . . .'' (83 Cong. Rec. 5042).

The only discussion of the amendment was by its supporters, who indicated that they had in mind authorizing the usual and ordinary LIFO method, involving items whose cost would be taken as fixed once they were placed in inventory. 83 Cong. Rec. 5042ff.

When the amendment came out of conference, it no longer contained the words "last-in, first-out," and it was limited to certain industries. It prescribed the method of taking inventory in terms similar to those in the present law. The managers in conference on the part of the Senate indicated that, except for the limited scope of application, the intent of the conferees was to enact the Senate floor amendment. 83 Cong. Rec. 6440ff.

The Revenue Act of 1939 made the LIFO section applicable to all taxpayers with fungible inventories and phrased it in virtually its present form. The committee report accompanying the bill explained that the only purpose of the changes was to make the optional method applicable to more taxpayers. S. Rep. No. 648, 76th Cong., 1st Sess.

This legislative history indicates that Congress intended to allow those taxpayers who could qualify under Section 22(d) to use the LIFO method of inventory evaluation. It also seems clear that Congress assumed that the "cost" of a particular item in inventory, once determined as of some date (usually the date of acquisition), does not change.

The Government's position in this case thus appears to be in conflict with the congressional intent in that the effect of the Government's method would be to require the taxpayer to abandon LIFO accounting as to the floor stocks taxes. The object of LIFO is to allow rising costs of doing business to be set against current income rather than be applied to inventory and recovered at a future time. Yet,

as to the increased inventory replacement cost represented by the floor-stocks taxes, the Government urges that these be added to inventory valuation to be recovered at some time in the future when these items, assumed to be the last sold, are disposed of. This would have the effect of deferring the recovery of these particular costs until taxpayer's inventory is finally liquidated, a result quite the opposite of that intended when Congress permitted the use of LIFO in inventory valuation.

The taxpayers's position here is also well supported by established accounting theory and practice. See Wixon, *Accountant's Handbook*, § 17 (4th ed. 1957). In defining the "cost" of a LIFO inventory, the one time (per item) expenses involved in the acquisition of goods are properly allocable to the cost of the goods. On the other hand, the typical recurring expenses of inventory maintenance, such as state and municipal personal property taxes, insurance and warehousing, are unquestionably chargeable to the day-to-day expenses of running the business. The floor stocks taxes here in question are akin to these expenses of maintaining an inventory, in that they are merely a cost necessary to its continued existence.

There remain two points urged by the Government which need a word of discussion. The first is that the Commissioner's action in assessing the deficiency was within Section 22(d)(3), as a regulation to insure that the plaintiff's return "clearly reflects income." However, the Commissioner has issued no regulation which supports the Government's position in this action. The only regulations pertinent to the case merely restate the Senate Finance Committee's explanation of the section. In fact, the regulations tend to support the plaintiff's position, as they, too, are written with the implicit assumption that historic cost, once established in accordance with the statute, does not change. Treas. Reg. 111, § 29.22(d).

In any event, if, as legislative history and the wording of the statute indicate, Congress intended to allow the use of LIFO, then it would seem to be beyond the authority of the Commissioner to issue a regulation requiring a taxpayer who has properly elected LIFO to use instead a system that is LIFO only in part and defers recovery of those expenditures which the Commissioner deems appropriate to so require.

The Government also directs my attention to the case of *Lucas* [sic] v. *Structural Steel Co.*, 281 U.S. 264 (1930), in which the Supreme Court upheld the Commissioner's action in ruling the "base stock" system of inventory evaluation invalid as not clearly reflecting income. That case would indeed be apposite if Congress had not, in the meantime, passed the LIFO provision of the Internal Revenue Code. To the extent that that case is authority for denying to taxpayers the use of LIFO, it has obviously been overruled by Congress, as regards taxpayers who come within the scope of Section 22(d).

The floor stocks taxes are excludable from the cost of the LIFO inventory. Judgment for the plaintiff may be entered.

THEODORE LEVIN
Chief United States District Judge

Dated: Detroit, Michigan
December 28, 1961

APPENDIX B

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee,*

-v-

UNITED STATES OF AMERICA, *Defendant-Appellant.*

ON APPEAL from the United States District Court for the Eastern District of Michigan.

Decided October 21, 1963.

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

WEICK, Circuit Judge. The action in the District Court was to recover income and excess profits taxes alleged to have been overpaid for the fiscal years ended September 30, 1943, September 30, 1944 and June 30, 1951 in the amount of $83,691.45 including accrued interest.

The legal question involved was whether taxpayer, a manufacturer of alcoholic beverages, in computing its income, may deduct, as an ordinary and necessary business expense, floor stocks taxes imposed on its distilled spirits on hand instead of adding such taxes to the cost of its inventory in accordance with its previous practice.

The District Court ruled in favor of taxpayer permitting the floor stocks taxes to be expensed and the Government appealed.

Taxpayer, with the approval of the Commissioner of Internal Revenue, had elected to inventory its distilled spirits and finished products on the Lifo (last-in-first-out) method. Its original inventory was computed at cost as of

October 1, 1942, the commencement of its fiscal year. At that time the excise tax on distilled spirits was $4.00 per proof gallon which taxpayer had paid and included in its inventory as part of the cost of its distilled spirits.

Effective November 1, 1942 Congress increased the excise tax on distilled spirits from $4.00 per proof gallon to $6.00 per proof gallon. This tax was imposed on distilled spirits on distillation or removal from bond on which no previous excise tax had been paid. In order to reach distilled spirits on hand which had been subject to the lower excise tax, Congress enacted a floor stocks tax of $2.00 per proof gallon. This applied to spirits in taxpayer's opening inventory. The purpose of the floor stocks tax was to equalize the tax on all distilled spirits so that the increased tax would be included in the price of all spirits sold after the date of the tax increase.

In 1944, the excise tax on distilled spirits was increased by the amount of $3.00 per proof gallon and again in 1951 by $1.50 per proof gallon. In said years floor stocks taxes were also imposed in the respective amounts of $3.00 and $1.50 per proof gallon on stocks of distilled spirits on hand. Floor stocks taxes are included in the general classification of excise taxes. The parties to this case in their briefs, however, used the term "floor stocks taxes" when considering them and "excise taxes" when referring to taxes other than floor stocks taxes.

Taxpayer's Lifo beginning inventory in 1942 contained both excise taxes on distilled spirits and floor stocks taxes which had been included as part of the cost of goods on hand. The floor stocks taxes imposed thereafter in 1942, 1944 and 1951 were paid by taxpayer and the amounts thereof were not added to the ending inventories in those years, but treated as ordinary business expenses. The Commissioner disallowed the deductions and added the floor stocks taxes to taxpayer's closing inventory in the applicable tax years.

Excise taxes imposed in 1942 and thereafter were treated by taxpayer as a cost to be included in inventory produced or obtained after the effective date of such taxes.

The tax consequences of taxpayer's treatment of the floor stocks taxes were that it had a deduction from income for the full amount thereof and by not adding the amount of such taxes to its closing inventory for the year on which the taxes were increased, the inventory did not reflect the tax increase. The effect of this was to increase taxpayer's cost of goods sold thereby decreasing its profits subject to income taxes.

It is the contention of taxpayer that the beginning inventory in the Lifo method must be fixed at cost and once established is frozen and cannot be changed.[1] Cost is de-

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[1] "(d) *Method of inventorying goods.* (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method."

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"(3) The change to, and the use of, such method shall be in accordance with such regulations as the Commissioner, with the approval of the Secretary, may prescribe as necessary in order that the use of such method may clearly reflect income.

"(4) In determining income for the taxable year preceding the taxable year for which such method is first used, the closing inventory of such preceding year of the goods specified in such application shall be at cost." [Section 22(d), Internal Revenue Code of 1939; 26 U.S.C.; 1952 ed., Section 22(d)]

fined in the regulations.[2] Taxpayer contends that the action of the Commissioner in adding the floor stocks taxes to its closing inventory as part of the cost of goods was unauthorized.

The taxes in this case comprise a large portion of the cost of the distilled spirits and of their selling price. The floor stocks taxes were imposed on the amount of distilled spirits on hand and relate directly to them.

The general purpose of the enactment of the statute providing for the Lifo method was to afford relief against inventory profits in a rising market. *R. H. Macy & Co.* v. *United States*, 255 F. 2d 884 (CA 2). We find nothing in the legislative history reflecting on the issue here involved.

As we see it, we are not concerned with whatever right the taxpayer had initially to expense excise taxes or add them to its inventory.

Section 23 of the Internal Revenue Code of 1939 authorized their deduction as ordinary and necessary business expenses.

The regulations permit the inclusion of excise taxes as part of the cost of an inventory. Section 29.23 (C)-2 of Treasury Regulations 111.

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[2] "SEC. 29.22(c)-3. *Inventories at Cost.*—Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods."

* * * * *

"(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit."

Accounting principles recognize the addition of excise taxes to the cost of inventory. Patton & Dixon, Essentials of Accounting (1958), p. 253; Wixon, Accountants Handbook, pp. 5, 6, 33-35.

In 2 Mertens, Law of Federal Income Taxation (Rev. ed. 1961) § 16.17, the author states: "Customs duties and excise taxes may at the option of the taxpayer be deducted from gross income as business expenses or added to the cost of the goods.

Specifically, our problem is whether taxpayer, having included excise and floor stocks taxes in his opening Lifo inventory, may depart from this practice and expense the floor stocks taxes imposed in the subsequent years.

Consistency is required in inventory practices from year to year. Once a taxpayer has treated floor stocks taxes as part of the cost of merchandise purchased he may not deviate from this practice in subsequent years. *Guy T. Gibson, Inc.* v. *Commissioner*, 46 B.T.A. 1015; *Bobrow Bros., Inc.* v. *Commissioner*, 135 F. 2d 209 (CA 3); Treasury Reg. 29.22 (C 1-2) promulgated under Internal Revenue Code of 1939; 2 Mertens, Law of Federal Income Taxes § 16.06.

Conceding that under the Lifo method the costs of a beginning inventory are frozen, we do not see how this affects the manner in which costs subsequently incurred should be treated in the closing inventory. If such costs are properly attributable to the goods on hand they ought to be reflected in the closing inventory irrespective of whether Lifo, Fifo, or any other method is used. Under Lifo, however, the cost of the beginning inventory for the subsequent year must be taken from the closing inventory of the previous year.

The Commissioner is not without power to compel consistency in inventory practices. We think Section 22(c) of the Internal Revenue Code of 1939 confers power upon

him to conform any inventory to the best accounting practice which most clearly reflects income.

In our judgment, it was not unreasonable for the Commissioner to do so in the present case.

The judgment of the District Court is reversed and the cause is remanded with instructions to dismiss the complaint.

APPENDIX C

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee*,

-vs-

UNITED STATES OF AMERICA, *Defendant-Appellant*.

Order

(Filed December 2, 1963)

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

In its petition for rehearing, taxpayer contends, inter alia, that since floor stocks taxes were not included in its beginning inventory in 1942, we erred in holding that the floor stocks taxes should be treated as part of the cost of the closing inventories for the applicable tax years.

This proposition is not only contrary to the briefs and record herein, but also in reply to this Court's written Interrogatory submitted to the parties, viz: "Whether it is agreed that the cost of the opening inventory on October 1, 1942, included *both excise and floor stocks taxes* paid on distilled spirits on hand?" Appellee's answer thereto was as follows: "Appellee agrees that such costs were so reflected in the cost of its inventory as determined October 1, 1942."

Taxpayer was not required to include its excise and floor stocks taxes as part of its opening inventory, but as stated in our opinion: "Once a taxpayer has treated floor stocks taxes as part of the cost of merchandise purchased he may not deviate from this practice in subsequent years."

The petition for rehearing is denied.

PAUL C. WEICK
United States Circuit Judge

APPENDIX D

Stipulation of Question Involved and Facts Years Involved in Controversy

(Filed December 17, 1958)

Plaintiff's claim is predicated upon alleged over-payment of income taxes and excess profit taxes, and assessed interest thereon, as follows:

		Taxes	Assessed Interest
Fiscal year ending Sept. 30, 1943:			
Excess profits tax of		$70,648.35	$21,427.30
Fiscal year ending Sept. 30, 1944:			
Excess profits tax of		10,010.41	1,206.81
Fiscal year ending Sept. 30, 1945:			
Income tax of		(5,740.30)	
Excess profits tax of		816.41	
Fiscal year ending Sept. 30, 1946:			
Income tax (deficiency) of	12,318.91		
Excess profits tax (deficiency) of	7,878.64		
		(20,197.55)	
Fiscal year ending June 30, 1951:			
Income tax of		5,520.02	
		$61,057.34	$22,634.11
		22,634.11	
	Total	$83,691.45	

Taxpayer's fiscal year was changed to terminate June 30 on July 1, 1950.

STIPULATION OR NATURE OF CONTROVERSY OR QUESTION INVOLVED

It is Hereby Stipulated and Agreed that taxpayer kept its books under a method of inventorying its finished products and distilled spirits (exclusive of excise tax on

distilled spirits in bond) on the Lifo basis, pursuant to** Section 22(d)(1) (a) (b) and (c) of the Internal Revenue Code of 1939, as amended. Revenue Act of 1939, 26 U.S.C. 219.

The dispute involved arises over the manner in which the taxpayer shall compute its inventory by reason of the increase of taxes upon distilled spirits by the Revenue Act of 1942, the Revenue Act of 1943, and the Revenue Act of 1951.

As of October 1, 1942, when plaintiff determined its opening inventory at cost, the excise tax on distilled spirits, as provided by the Internal Revenue Code of 1939, was $4.00 per proof gallon, and this amount was included by plaintiff in determining its cost of finished products and distilled spirits, exclusive of distilled spirits in bond, as comprising its opening inventory as of October 1, 1942.

Under the provisions of Sections 601 and 602 (a to d) of the Revenue Act of 1942, and Sections 2800(a)(1) and

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**Inventories:

(a) Amendment to code. Section 22(d) of the Internal Revenue Code (relating to inventories in certain industries) is amended to read as follows:

(d) (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c),) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost:

(B) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

2800 (J), I.R.C., the excise tax on distilled spirits was increased from $4.00 per proof gallon to $6.00 per proof gallon, effective November 1, 1942, and a floor stock tax of $2.00 per proof gallon was imposed on distilled spirits on hand on November 1, 1942.

Under the provisions of Section 308(a) of the Internal Revenue Act of 1943 (Sec. 2800(K) I.R.C., effective April 1, 1944, the excise tax on distilled spirits was increased an additional $3.00 per proof gallon.

Under the provisions of Section 451(c) of the Internal Revenue Act of 1951 (Sec. 2800(1) I.R.C., effective November 1, 1951, the excise tax on distilled spirits was again increased an additional $1.50 per proof gallon.

In each year when the floor stock tax became effective, the additional tax on the distilled spirits then on hand was paid by the plaintiff, and in its Federal income and excess profits tax return filed for each of those years the plaintiff deducted the amount of the floor stock tax paid as a business expense. The deduction was denied by the Commissioner of Internal Revenue, and added to the closing inventories of the plaintiff as a part of the costs of distilled spirits on which the tax was imposed.

The plaintiff contends that to the extent that the portion of the floor stock taxes so paid, which represented the amount of such tax upon its original opening inventory under the Lifo method, the Commissioner was in error.

The effect of these three additional taxes on distilled spirits upon the computation of plaintiff's inventory, as computed by plaintiff, and as adjusted by the Commissioner of Internal Revenue, is set out in the attached schedule marked "Schedule A". [R. 16-17]

STIPULATION OF FACTS

It is Hereby Stipulated and Agreed That:

(1) Plaintiff, Mohawk Liqueur Corporation, is a corporation organized on October 14, 1933, under the laws of the State of Michigan.

(2) This Court has jurisdiction of this cause by virtue of Title 28, U.S.C. 1346, as amended by the Act of July 30, 1934.

(3) Prior to the commencement of this action, the plaintiff had duly filed claims for refund, which included the amounts here in controversy, and more than six months had elapsed before institution of this suit.

(4) Plaintiff's books were kept on a fiscal year basis for the period involved in this action, its fiscal year ending on September 30th of each calendar year, until July 1, 1950, at which time the fiscal year was changed so that the fiscal period terminated in each calendar year thereafter on June 30th.

(5) All issues other than the question here involved have been resloved.

(6) All sums sought to be recovered have been duly assessed, either as income taxes or excess profits taxes, together with assessed interest, and have by the plaintiff been paid

Mohawk Liqueur Corporation

By /s/ Fred R. Walker

United States of America,
Defendant

Fred W. Kaess,
U.S. Attorney,

By /s/ Ealine L. Pfuphat,
Assistant U.S. Attorney.

APPENDIX E

Statutes and Regulations Involved

Internal Revenue Code of 1954:

Sec. 471, Internal Revenue Code of 1954:

> Sec. 471. Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 472, Internal Revenue Code of 1954:

> Sec. 472. (a) Authorization.—A taxpayer may use the method provided in subsection (b) (whether or not such method has been prescribed under section 471) in inventorying goods specified in an application to use such method filed at such time and in such manner as the Secretary or his delegate may prescribe. The change to, and the use of, such method shall be in accordance with such regulations as the Secretary or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.
>
> (b) Method Applicable.—In inventorying goods specified in the application described in subsection (a), the taxpayer shall:
>
> (1) Treat those remaining on hand at the close of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year;
>
> (2) Inventory them at cost; and
>
> (3) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.
>
> (c) Condition.—Subsection (a) shall apply only if the taxpayer establishes to the satisfaction of the Secre-

tary or his delegate that the taxpayer has used no procedure other than that specified in paragraphs (1) and (3) of subsection (b) in inventorying such goods to ascertain the income, profit, or loss of the first taxable year for which the method described in subsection (b) is to be used, for the purpose of a report or statement covering such taxable year—

(1) to shareholders, partners, or other proprietors, or to beneficiaries, or

(2) for credit purposes.

(d) Preceding Closing Inventory.—In determining income for the taxable year preceding the taxable year for which the method described in subsection (b) is first used, the closing inventory of such preceding year of the goods specified in the application referred to in subsection (a) shall be at cost.

(e) Subsequent Inventories.—If a taxpayer having complied with subsection (a), uses the method described in subsection (b) for any taxable year, then such method shall be used in all subsequent taxable years unless—

(1) with the approval of the Secretary or his delegate a change to a different method is authorized; or,

(2) the Secretary or his delegate determines that the taxpayer has used for any such subsequent taxable year some procedure other than that specified in paragraph (1) of subsection (b) in inventorying the goods specified in the application to ascertain the income, profit, or loss of such subsequent taxable year for the purpose of a report or statement covering such taxable year (A) to shareholders, partners, or other proprietors, or beneficiaries, or (B) for credit purposes; and requires a change to a method different from that prescribed in subsection (b) beginning with such subsequent taxable year or any taxable year thereafter.

If paragraph (1) or (2) of this subsection applies, the change to, and the use of, the different method shall be in accordance with such regulations as the Secretary

or his delegate may prescribe as necessary in order that the use of such method may clearly reflect income.

(f) Cross Reference.—For provisions relating to involuntary liquidation and replacement of LIFO inventories, see section 1321.

Internal Revenue Code of 1939:

Sec. 22(c), Internal Revenue Code of 1939, ch. 1, 53 Stat. 11:

Inventories. Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 22(d)(1), Internal Revenue Code of 1939, ch. 1, 53 Stat. 11, as amended:

(d) Method of inventorying goods. (1) A taxpayer may use the following method (whether or not such method has been prescribed under subsection (c)) in inventorying goods specified in the application required under paragraph (2):

(A) Inventory them at cost;

(B) Treat those remaining on hand at the close of of the taxable year as being: First, those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof, and second, those acquired in the taxable year; and

(C) Treat those included in the opening inventory of the taxable year in which such method is first used as having been acquired at the same time and determine their cost by the average cost method.

Revenue Act of 1942, ch. 619, Sec. 601, 56 Stat. 970:

Sec. 601. Effective date of this title. This title shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1942, ch. 619, Sec. 602(d), 56 Stat. 971:

> (d) Floor Stocks Tax.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(j) 1942 Floor Stocks Tax.—
>
> "(1) Tax.—Upon all distilled spirits upon which the internal-revenue tax imposed by law has been paid, and which on the effective date of Title VI of the Revenue Act of 1942, are held . . . there shall be levied, assessed, collected, and paid a floor-stocks tax of $2 on each proof-gallon . . . ."

Revenue Act of 1943, ch. 63, Sec. 301, 58 Stat. 60:

> Sec. 301. Effective Date of This Title. This title shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1943, ch. 63, Sec. 308(a), 58 Stat. 67:

> (a) Distilled Spirits.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(k) 1944 Floor Stocks Tax.—
>
> "(1) Tax.—Upon all distilled spirits upon which the internal-revenue tax imposed by law has been paid, and which on the effective date of Title III of the Revenue Act of 1943, are held . . . there shall be levied, assessed, collected, and paid a floor stocks tax of $3 on each proof-gallon . . . ."

Revenue Act of 1951, ch. 521, Sec. 456, 65 Stat. 528:

> Sec. 456. Effective Date of Part V. The amendments made by this part shall take effect on the first day of the first month which begins more than 10 days after the date of the enactment of this Act.

Revenue Act of 1951, ch. 521, Sec. 451(c), 65 Stat. 525:

> (c) Floor Stocks Tax.—Section 2800 is amended by inserting at the end thereof the following new subsection:
>
> "(l) 1951 Floor Stocks Tax.—

"(1) Tax.—Upon all distilled spirits upon which the internal revenue tax imposed by law has been paid, and which on the effective date of section 451(a) of the Revenue Act of 1951, are held . . . there shall be levied, assessed, collected, and paid a floor stocks tax of $1.50 on each proof-gallon . . . ."

Treas. Reg. 111, Sec. 29.22(d)-1. Inventories under elective method—

Any taxpayer permitted or required to take inventories pursuant to the provisions of section 22(c), and pursuant to the provisions of sections 29.22(c)-1 to 29.22(c)-8, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 22(d). Under this elective inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

First, those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

Second, those acquired during the taxable year.

This elective inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of indentity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year. . . .

Treas. Reg. 111, Sec. 29.22(d)-2. Requirements incident to adoption and use of elective method—

The adoption and use of the elective inventory method is, by section 22(d) and regulations thereunder, made subject to the following requirements:

(1) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied;

(2) The inventory shall be taken at cost regardless of market values;

(3) Goods of the specified type included in the opening inventory of the taxable year for which the method is

first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the preceding taxable year with the exception that restoration shall be made with respect to any write-down to market values resulting from the pricing of former inventories;

(4) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices, at costs determined as follows:

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 22(d) as having been acquired all at the same time; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the elective inventory method is used by the taxpayer. . . .

* * * * *

Treas. Reg. 111, Sec. 29.22(c)-1, Need of inventories. In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary

in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment; but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see section 29.22(d)-1.)

Treas. Reg. 111, Sec. 29.22(c)-2. Valuation of inventories. Section 22(c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance

sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The bases of valuation most commonly used by business concerns and which meet the requirements of section 22(c) are (a) cost and (b) cost or market, whichever is lower. (For inventories by dealers in securities, see section 29.22(c)-5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect of normal goods, whichever basis is adopted must be applied with reasonable consistency to the entire inventory except as to those goods inventoried under the elective method authorized by section 22(d) or to animals inventoried under the elective "unit-livestock-price method" authorized by section 29.22(c)-6. Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in section 29.41-2.

Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 22(d) as to inventories under elective method. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual costs of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

Treas. Reg. 111, Sec. 29.22(c)-3. Inventories at cost. Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (a) the cost of raw materials and supplies entering into or consumed in connection with the product, (b) expenditures for direct labor, (c) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (a) farmers and raisers of live stock (see section 29.22(c)-6, (b) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see section 29.22(c)-7, and (c) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see section 29.22(c)-8).

APPENDIX F

No. 15006

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

MOHAWK LIQUEUR CORPORATION, *Plaintiff-Appellee,*

v.

UNITED STATES OF AMERICA, *Defendant-Appellant.*

On Appeal from the United States District Court for the Eastern District of Michigan

Judgment

(Filed October 21, 1963)

Before: CECIL, Chief Judge, WEICK, Circuit Judge, and TAYLOR, District Judge.

Appeal from the United States District Court for the Eastern District of Michigan.

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Michigan, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the cause remanded with instructions to dismiss the complaint.

Approved for entry:

s/ PAUL C. WEICK
United States Circuit Judge